

APPENDIX

NOTES FOR FOMC MEETING
March 26, 1985
Sam Y. Cross

During the six weeks since the last FOMC meeting, there has been a great deal of activity and considerable turmoil in the foreign exchange markets. The dollar has covered a lot of ground in both directions and after a number of ups and downs it is now trading a bit below the levels of six weeks ago.

For the first two weeks of the intermeeting period, the dollar rose sharply, moving from one record level to another. During those weeks the dollar was bolstered by continuing evidence that the U.S. economy and monetary aggregates were expanding more strongly than had been expected, and by expectations that the Federal Reserve would respond by tightening policy.

In addition, market professionals had come to doubt that central banks would offer much resistance to a further rise of the dollar. The dollar/mark rate had already risen well above DM 3.18--a level where intervention had succeeded in stopping the dollar's rise in earlier months. The market's skepticism about central banks' willingness and ability to stem the continued climb in the dollar this time persisted even though central banks did intervene in fairly large amounts. During the first two weeks after the last FOMC meeting, from February 12-26, they sold a total \$3.3 billion. The U.S. also intervened, on one occasion--February 19 when we sold \$65 million against marks and \$16.4 million against sterling, split equally between the Treasury and the Federal Reserve.

As the dollar continued to rise, reaching almost DM 3.48, there was increasing concern, particularly among European central banks, with both the speed of the dollar's rise and the high levels it was reaching. In late February, at a time when the dollar was

fluctuating widely around those very high levels, the central banks with the Bundesbank in the lead mounted a large-scale, coordinated intervention effort, selling a total of \$4.1 billion in the three days from February 27 to March 1. The U.S. sold \$257.5 million against marks as part of the concerted operations during those three days, again split between the Treasury and the Federal Reserve. On the second day of this operation, the U.S. authorities operated pari passu with the Deutsche Bundesbank, which left an order with the Desk to sell dollars. On the third day five other European central banks joined the U.S. and German authorities in operating in the New York market. Foreign exchange dealers saw the Desk intervening in as many as 6 currencies, and this approach helped to dispel the impression that the central banks were in disarray over intervention.

After the end of this Thursday concerted effort, the results were first judged to be inconclusive. On the one hand the momentum of the dollar's rise was broken, at least for a while. On the other hand, many were impressed that the dollar did not fall precipitously under the pressure of heavy intervention, and they noted that demand for dollars for a variety of needs from a variety of sources remained strong.

Later on, newly released statistics raised questions about the prospects for continued strong growth in the U.S. economy, the dollar began to weaken. The exchange markets interpreted these statistics as a sign that the Federal Reserve might ease monetary policy, leading to downward pressure on the dollar. The heavy weight of dollars left in private hands by the central banks' earlier interventions--totalling \$10 billion since the G-5 meeting in mid-January--probably contributed to this shift in sentiment.

Thus, when news broke of the Ohio savings and loan problem, the markets were nervous and vulnerable. Abroad, particularly in Europe, the TV image of depositors standing in line to withdraw funds aroused concern about the U.S. banking system in general and about the dollar. At least initially, many foreigners, unaware of the precise magnitude of the Ohio problem were reminded of Continental Illinois and feared a further shaking up of financial markets. Thus, it triggered a large sell-off of dollars and the dollar fell sharply in extremely active trading, reaching a low of DM 3.18 last week. Even after it appeared that banking authorities were acting to deal effectively with the Ohio situation, the exchange markets were influenced by the monetary policy implications, expecting the U.S. monetary authorities would have no room to tighten and might even ease in these circumstances.

At present, the dollar has recovered somewhat from its lows for the period. But market confidence has been shaken. Large-scale buyers of dollars, commercial and speculative, are not being seen as they were earlier in the year. Market participants are looking for the next convincing signs about strength in the U.S. economy, as an indication of the next move in the dollar.

During the period the state of the market deteriorated seriously. Trading conditions were generally described as "sloppy," "totally unsatisfactory," "the worst in years," and so forth. Spreads became very wide, interbank trading fell off, and at times market makers reportedly disappeared for corporate customers as well as interbank counterparties. The market could move rapidly and by large amounts, first in one direction and then another, with little tendency to stabilize by itself.

Thus a lot has happened to the dollar in the past six weeks, and the pundits can draw a lot of morals. For one thing we've seen that the central banks can still mount a rather large intervention effort on occasion. And we've seen that the dollar can stand pretty firm despite the pressure of heavy intervention. But we've also seen evidence of the dollar's vulnerability to significant changes in expectations, whether related to shifts in economic prospects or to an event like the one in Ohio.

NOTES FOR FOMC MEETING
March 26, 1985
Peter D. Sternlight

Desk operations since the last meeting were directed at maintaining roughly similar conditions of reserve availability to those prevailing in the weeks before that meeting. The narrow money supply measure was quite strong relative to the Committee's preferred path through most of the period, although a noticeable deceleration toward the end appeared to be producing M1 growth for December to March only modestly above the desired 8 percent track. Growth in M2 was a bit to the high side through February, but seems to have moderated enough in March to result in December-March growth around the low end of its anticipated 10-11 percent range, while M3 tracked to the low side of its 10-11 percent 3-month range through the period. It might be noted, though, that the moderate behavior of the broader aggregates was in relation to rather substantial path rates for those measures--rates that if continued would have seen those aggregates run well ahead of the Committee's longer-term preferences.

While reserve paths consistently incorporated a \$350 million allowance for seasonal and adjustment borrowing, actual borrowing tended to run appreciably higher than that. In part, this reflected a tendency for excess reserve demands to exceed the \$600 million path allowance, while nonborrowed reserves actually ran fairly close to path. In part, too, the higher borrowing levels reflected some day-to-day reserve shortfalls, as well as some

willingness on the Desk's part to be not too concerned about somewhat higher borrowing given the substantial strength in M1 through much of the period. In the two full maintenance periods since the last meeting, borrowing averaged about \$600 million, while thus far in the current period, it is averaging around \$480 million. A small part of the recent borrowing is due to Ohio thrifts.

Federal funds centered largely around $8 \frac{1}{2}$ to $8 \frac{5}{8}$ percent during the period, although the average was $8 \frac{3}{4}$ in the first half of the current reserve period apparently reflecting the tight wind-up to the previous maintenance period and possibly some impact of the mid-March tax date. Recent days have seen funds closer to the $8 \frac{1}{2}$ area. Trading around $8 \frac{1}{2}$ - $8 \frac{3}{4}$ percent seems to be about the level currently anticipated by market participants, although at times during the intermeeting period there were widespread expectations of seeing the rate at 9 percent or possibly higher as a normal condition.

The Desk met sizable reserve needs during the period, chiefly through outright purchases of Treasury bills and notes. From the start of the period through March 4, the System bought about \$4.6 billion of securities, including \$1.8 billion of bills in the market and \$2.8 billion of bills and notes from foreign accounts--the latter chiefly reflecting sales undertaken by these accounts to support their currencies when the dollar was exceptionally strong in late February. The System's large purchase

of notes from foreign accounts avoided the need to press the foreign account sales on an unreceptive market. As the Desk's purchases more than met reserve needs for early March, we followed up by running off \$500 million of bills in an auction and selling about \$550 million of bills to foreign accounts. Most recently, we've turned again to some outright purchases from foreign accounts as we look toward very substantial reserve needs in the next several weeks. The net increase in the System's outright holdings over the period was about \$3.7 billion. Outright operations were supplemented by repurchase agreements--either System or customer related--on 14 occasions, while reserves were withdrawn through matched sale-purchase transactions in the market on one occasion.

Market interest rates generally rose over the intermeeting period against a background of shifting day-to-day sentiment and news, but with investors apparently more impressed with the bearish side. The Chairman's comments in Congressional testimony that a period of easing had ended did not really do more than confirm what most participants and observers had already concluded, but having that official confirmation seemed to condition the market to be on a continual lookout for a firming tendency. From time to time some observers thought they either saw that firming, or saw reason for it, in the occasionally firmer money market, higher borrowing numbers or robust growth of money supply. At times, the domestic market was also particularly sensitive to signs of weakness in the dollar, seeing this as both a reason that policy would not be

inhibited from firming and that foreign demands for U.S. securities would likely let up or possibly reverse with a changed dollar outlook. Occasional countervailing developments in money supply numbers, borrowings, or sometimes softer economic data spawned some brief professionally dominated rallies but did not seem to arouse significant investor interest. Through most of the period market participants remained skeptical about the likelihood of significant action to reduce the Federal deficit.

The failure of EMS Government Securities--and the ripple effects on thrift institutions and some municipal governments--was not a major factor affecting domestic market price developments or trading practices, probably because dealers came through relatively unscathed. However, the incident was certainly a conversation piece, particularly provoking renewed attention to the possibilities for regulation of the Government securities market. There was the start of a flight to quality in the bill market the day the Governor of Ohio closed 70 non-Federally insured thrifts, but the flight never got far off the ground. There was some reviewing and pulling back here and there on repo lines, and talk of possible restrictions on the brokers' market that serves the primary dealers for outright trades on a no-name basis, but there was nowhere near the anxiety that gripped the market for a time after the Drysdale collapse in 1982. As to the conversation about regulation, my sense is that many more participants in the market are now reconciled to the likelihood of a more formal and potent regulatory presence than was

the case after previous market episodes of this kind. Obviously, the regulation question now presents itself quite forcefully for consideration by the Fed, other agencies, the Congress and the public.

Returning to market developments over the recent period, against the background factors noted earlier, rates on Treasury coupon issues rose roughly 50 basis points. New Treasury cash borrowing in the coupon area was a relatively moderate \$9 1/2 billion, although starting today the market embarks on the end-of-quarter batch of 4-, 7- and 20-year issues, which will raise nearly \$13 billion new cash, and this prospect also tended to cast its shadow over the recent period.

Meantime, bill rates rose about 20 to 60 basis points over the interval, while the Treasury raised about \$4 billion in that sector. In yesterday's bill auction, the average rates were about 8.41 and 8.86 percent for the 3- and 6-month issues, as compared with 8.20 and 8.28 percent just before the last meeting.

As for the current outlook, I think most market participants anticipate somewhat higher rates over the next several months, perhaps influenced by the fairly heavy atmosphere of the past two months. But one is also beginning to sense elements that could change this preponderant view, including the recent evidence of slower money growth, slower growth in the economy and even perhaps a glimmer of hope on the budget front.

J.L. Kichline
March 26, 1985

FOMC BRIEFING

Economic activity in the first quarter appears to have been expanding at a somewhat slower pace than late last year. Domestic spending picked up, associated with strong consumption, but a good deal of the demands appear to have been satisfied by imported goods. The projected growth of real GNP this quarter was revised down to 3 percent owing to the greater deterioration in net exports than earlier anticipated. Over the balance of the forecast period, however, the picture is essentially the same as that presented at the last meeting of the Committee, with only slight downward adjustments to projected real growth and inflation.

The attraction of imported products is one of the forces taking its toll on domestic production. The industrial production index is estimated to have declined 1/2 percent in February and there were downward revisions to output in each of the three preceding months; weakness in production in February was broadly based among consumer and business products. Aside from import competition, domestic output apparently is still being constrained by some lingering inventory problems and in February by adverse weather. The weakness in output has led to a decline in

capacity utilization, which in February was back to levels seen a year earlier.

Hours worked and employment declined last month for the manufacturing and construction sectors, but employment gains continued in the trade and services area. Total nonfarm employment rose more than 200,000 per month on average for January and February, less than during the fourth quarter but still a good increase. The unemployment rate dipped a tenth to 7.3 percent in February, staying in the narrow range that has prevailed for more than half a year.

The slower growth of employment early this year has been accompanied by somewhat smaller increases in personal incomes. That, however, evidently has not been a deterrent to consumer spending, and for the quarter as a whole we are projecting an increase of real consumer spending at a 6 percent annual rate. Auto sales have been especially strong at around an 11 million unit annual rate, up appreciably from the fourth quarter. The growth was accounted for by domestic makes as Japanese models are in relatively short supply as the quota year draws to a close. Over the forecast period we do not anticipate further growth in auto sales, and expect that foreign models gradually will capture a larger share of the market. Outside of the auto

area consumer spending perked up in February following a decline in the preceding month. Beyond the current quarter we expect growth of spending to moderate and move more in line with growth of income.

For the housing sector, aggregate developments on average have been about as expected. Single-family home starts have been edging up, while the volatile multi-family starts also have advanced on average. The forecast has not been changed significantly and we continue to believe that housing starts will be around 1-3/4 million units annual rate in the future, marginally higher than in the first quarter.

Business fixed investment is an area that is key to the forecast and also where current indicators are a bit hard to read. We made a small downward revision to the forecast, and the roughly 7 percent real growth this year builds in substantial moderation--projected growth is half the rate registered in each of the past two years. The moderation is based upon slowing of output gains, limited pressures on capacity, and weakness in projected growth of corporate profits. The indicators of recent and prospective spending have been mixed. Shipments of nondefense capital goods fell sharply in January and recovered only a little in February; however, imports of capital goods were up

considerably in January. New orders at domestic producers skyrocketed in February but we can't be sure that this marks a reversal of the downtrend observed over the past half year. Nonresidential construction spending has continued up, although high vacancy rates are sure to damp office building construction at some point. Our forecast basically is in line with survey evidence and seems to be a reasonable bet, but developments in the investment area are not particularly comforting. As an aside I might note that the Commerce Department in its flash estimate of GNP for the first quarter showed no growth in business fixed investment and that is the principal reason for their lower GNP estimate.

Wage and price developments generally remain in line with expectations and have not exhibited any fundamental sense of departing from recent trends. Fixed-weighted business product prices are expected to rise around 3 to 3-1/4 percent annual rate this quarter, with the deflator about a percentage point higher.

The situation in Ohio appears to have been kept relatively isolated, without large spillover effects on national markets. Nonetheless, there have been a few signs that confidence in the stability of the financial system has been shaken a bit. The most noticeable was the very sharp drop in the value of the dollar on exchange markets. Another was the opening for a brief period of a relatively wide spread of private short-term interest rates over Treasury bill rates, as the latter fell.

I would also note that long-term markets have not been showing signs typical of underlying confidence. Day-to-day price movements have been large and volatile. And long-term rates have trended up, rising as much or more than short-term rates. Lack of progress on the budget has been one contributor. Fear that foreigners might begin disinvesting as confidence in U.S. markets wanes has been another. There have also been doubts, despite rather tranquil over-all price and wage figures, about whether progress against inflation can be continued; the most recent survey by Hoey showed some little increase in inflationary expectations. Reasons for such a change in attitude are not totally clear. The increased probability of a decline in the dollar is one. In addition, market participants could have more doubts, as publicity about difficult debt problems continues unabated, about whether large debt burdens of the federal government, farmers, foreigners and--beginning to appear--for businesses and consumers may not inevitably lead to mounting inflationary pressures (to in effect ease the real burden of the debt). Recent heightening of such doubts might be allayed if money growth does slow markedly, as we currently expect for March.

These various financial market disturbances have occurred amid considerable fluctuation in attitudes about the real economy. They have ranged between fairly bullish, as retail sales appeared quite strong, to considerably less so as uncertainties have increased about the underlying strength of capital spending and as imports rose. As consumers continue diverting a significant amount of their spending to imports, the willingness of business to expand in this country may be waning. That of course raises the question of how long can sufficient income be generated here to sustain spending if the pattern of spending means that U.S. businesses will be faced with shrinking markets and less and less profitable investment opportunities. However that may be, uncertainties about the actual sustainability of our economic expansion have not appeared to dominate financial markets, or at least not for very long. I would believe, though, that they are--like Ohio, agricultural and foreign debt, and the federal deficit--another element adding to the sense of uncertainty and related volatility that at present appear to pervade domestic credit and foreign exchange markets.

The alternatives presented in the blue book do not suggest that it will be easy to reconcile any desire by the Committee to keep M1 within its long-run band with an approach that in the short run helps to ease market concerns. Given the pressures on money demand from the expected expansion of real GNP next quarter, and making some allowance for the fact that our models still show some lagged effect on money demand from earlier interest rate declines, we would expect expansion of M1 over the next three months to be around 6-1/2 percent at an annual rate, given something like current pressures on bank reserve positions.

Such a rate of growth would take M1 from an expected position in March just below the upper limit of its long-run band to one in June just above it. That might not lead markets to believe that an immediate policy tightening was in prospect, since the rate of growth in M1 would be considerably slower than in the first quarter. But such a rate of expansion would still mean that growth in the second half of this year would have to slow further to be at the upper point of the band by year-end, and further still if growth for the year were to be below 7 percent—say 6 to 6-1/2 percent. Unless the rate of inflation or growth in real GNP were continuing to slow, this more limited expansion of M1 might well not be achievable without further increases of interest rates.

There are some reasons to expect, or at least hope, that M1 growth could slow more than specified under alternative B over the next three months, given current money market conditions. It may be that the lagged effects on money demand of declining interest rates are now shorter than our models suggest if deregulation has also led to increased alertness on the part of the public to the returns on deposits and alternative instruments. Secondly, financial conditions may be basically tighter than recent M1 growth may imply. A little evidence for that might be adduced from the lack of aggressive CD offerings by thrifts and banks recently—reflected in a marked deceleration of M3 earlier than for M1—that may be associated with some conservativeness in lending policies. If so, there could be a little more restraint on nominal GNP growth and money demand than we currently suspect.

A slowing of M1 to the alternative B pace, or less, would avoid what could be a considerable dilemma for the Committee. Given recent financial and nonfinancial developments, an argument can be

made that the economy and financial markets may be a little too fragile at this point to withstand much additional restraint on reserve positions should that be needed to restrain M1 growth. On the other hand, growth of M1 much above the alternative B pace would appear to cast doubt upon the ability of the FOMC to attain the 4 to 7 percent long-run target for M1, with some danger to the credibility of the FOMC's anti-inflationary stance. Sustained growth above target--which could involve the need to consider readjusting the target at midyear--would be of less concern in the degree that there was evidence of a substantial upward shift in demand for money relative to income. But thus far there is not much evidence of that. Institutional changes do not appear to be raising money demand significantly; and economic and financial uncertainties do not seem to explain strong money growth earlier this year, as that growth rather appears to represent a normal response to lower interest rates.

Under these conditions, in terms of policy response to variations in money behavior, a relatively slow growth in M1 would provide an opportunity to permit some easing in money market conditions to help alleviate recent market concerns, though a good case can also be made that slow M1 growth might be accommodated without an easing, at least for a while and up to a point, to enhance flexibility later in the year. Should M1 growth be relatively rapid, on the other hand, it would seem that such growth would need to be resisted to provide scope for adequate expansion in money later this year, absent relatively clear signs of a weak economy and unstable financial and exchange markets that suggest the Committee's long-run target for M1 does not appropriately allow for enhanced demands for liquidity. However, if

the economy and markets are indeed in a rather fragile state, the fragile is correct, the Committee in resisting money growth, even though cautiously and probingly, may have to be prepared for a more pronounced impact than usual on lending policies and demands for goods and services— which is just another way of saying that a little restraint in present circumstances may go a long way.